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IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

TRANS WORLD AIRLINES, INC.;
TRANSWORLD CORPORATION,

Petitioners,

—v.—

JOEL KRONFELD,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

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COUNTER-STATEMENT OF QUESTIONS PRESENTED

1. Should this Court adopt a bright-line test of materiality under the federal securities laws which ignores the significance of the information to a reasonable investor and focuses instead on whether the company's Board of Directors has formally acted upon the transaction in question?

2. Was the Court of Appeals correct in reversing the District Court's grant of summary judgment and allowing the case to go to the jury on the issue of materiality where evidence in the record would support a finding that the magnitude of the prospective event to shareholders considering an investment in the company was extremely high and there was a "substantial possibility" that the event would occur?

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Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

Respondent, Joel Kronfeld, respectfully submits that this Court should deny the Petition for Writ of Certiorari filed by Trans World Airlines, Inc. ("TWA") and Transworld Corporation ("TWC").

Respondent accepts the descriptions set forth in the Petition as to the "Opinions Below," "Jurisdiction" and "Statutes and Rules Involved." Petition ("Pet.") at 1-2. References herein to "____ a" are to pages of the Appendix contained in the Petition.

STATEMENT OF THE CASE

The question presented by this case is the materiality of misleading statements and omissions made by petitioners. These are factual questions unique to this case. The legal standards

concerning materiality are identical to those laid to rest by this Court's recent decision in *Basic Incorporated, et al. v. Max L. Levinson, et al.*, ____ U.S. ____ (No. 86-279 March 7, 1988).

In the decision below, the Court of Appeals applied the "probability/magnitude" balancing approach developed in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969) and adopted by this Court in *Basic v. Levinson*, Slip Op. at 13-16. Under this test, the facts relating to the probability of the occurrence of the transaction which is the concern of the disclosures are weighed against the facts relating to the magnitude of the event should it occur. Balancing these, the trier of fact is to determine the significance the reasonable investor would place on the withheld or misrepresented information.

Using this approach, the Court of Appeals found that there was sufficient evidence in the record for a jury to determine that the magnitude to investors of the event in question was extremely high and that there was a "substantial possibility" that the event would occur. Under these circumstances, held the court, it was a question of fact for the jury to decide whether a reasonable investor would consider it significant in making his investment decision that a "substantial possibility" existed that such an extremely important event would occur involving the company in which he was about to invest.

In reversing the District Court's grant of summary judgment, the Court of Appeals' holding was clearly in harmony with this Court's decision in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) that:

> In considering whether summary judgment on the issue is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those

> inferences to him, and these assessments are peculiarly ones for the trier of fact. [Footnotes omitted.]

Thus, the Petition raises no legal questions. Instead, it merely asks this Court to review the record and make its own determination as to whether this particular case should go to the jury.

Petitioners attempt to frame an issue of law for this Court to decide by asserting that the Court of Appeals established a "novel" and "especially strict" standard for summary judgment on the issue of materiality. (Pet. at 3). In fact, the Court of Appeals did nothing more than adhere to this Court's established holding in *TSC v. Northway* and the holdings of those cases applying the "probability/magnitude" analysis which were later adopted by this Court in *Basic v. Levinson*. Petitioners also attempt to invent an issue of law by exaggerating the holding below, declaring that it requires disclosure of "mere corporate possibilities" (Pet. at 3) and "every unfinished study of 'possible' future action" (Pet. at 11). The court below made no such sweeping pronouncements. Instead, it merely held that a jury could find that reasonable investors would find it important that a "*substantial* possibility" existed that the company in which they were about to invest would undergo a transaction of extremely high magnitude. This holding represents no change in the law of the Second Circuit and, after *Basic v. Levinson*, it represents the law of the land.

The Parties

Respondent Joel Kronfeld purchased 200 shares of TWA cumulative convertible preferred stock in a $100 million Public Offering commenced on July 29, 1983. The prospectus and registration statement issued in connection with the Offering are the subject of this action. The District Court determined that respondent could proceed pursuant to Fed. R. Civ. P. 23 on behalf of himself and a class of all other persons who purchased TWA preferred stock between July 29, 1983 and September 27, 1983.

Petitioner TWA, at the time of the July 29, 1983 Public Offering, was an 81% owned subsidiary of TWC. On September

28, 1983, TWC's Board of Directors announced that it was considering the possible spinoff or other separation of TWA.

Summary of the Claim

The complaint charged that the prospectus and registration statement on the July 29, 1983 Public Offering misrepresented and omitted material facts in violation of § 11 of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated by the Securities and Exchange Commission under § 10(b)[1].

Specifically, it was charged that petitioners failed to reveal that top management of TWC and the company's investment bankers were considering a plan to separate TWA from TWC and that a proposal in this regard would be presented to TWC's Board of Directors shortly after the Public Offering. This information concerning a possible spinoff was highly material to investors asked to invest $100 million in TWA. For years, TWA had lost money. It was able to continue operations only because it was supported financially by its parent company, TWC. Even the District Court, in rendering summary judgment against respondent, acknowledged that:

> It is not disputed that *the nature of the relationship between TWC and TWA*, in which TWC guaranteed much of the credit upon which TWA did business and financed its substantial requirements for operating capital, *was critical to the decisions faced by knowledgeable investors in evaluating TWA's value as an investment*, particularly in view of the fact that TWA had suffered substantial losses in the period before July 29, 1983.

631 F. Supp. 1259 at 1263; 43a (emphasis added).

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1 The statutes and rule are reprinted at 46a-53a.

Summary of the Facts

The Odyssey Proposal

In the months preceeding the July 29, 1983 Public Offering, TWC had successfully fought off a proxy contest (the "Odyssey Proposal") seeking to separate the various subsidiaries of TWC, including TWA, into separate companies.[2] The Odyssey Proposal had gained the support of large institutional investors with substantial holdings of TWC stock. In a last minute lobbying effort, Frank Salizzoni, Chief Financial Officer of TWC and a member of its Board of Directors and executive committee, met with major shareholders and persuaded them to withdraw their support for the Odyssey Proposal.[3] Nevertheless, the Odyssey Proposal still received approximately 23% of the vote (even though Odyssey itself held only about 1% of TWC's stock). On the day the vote was taken, Alliance Capital Management, a large institutional investor, informed TWC's President and Chairman of the Board, L. Edwin Smart, that although it had cast its 750,000 votes in favor of TWC, it saw "merit to the Odyssey plan" and hoped that TWC would be "spinning off to shareholders more of TWA." Other large shareholders who had voted against Odyssey also supported the concept of separation, but wanted "management [to] do it on their own."

On May 12, 1983, TWC issued a press release declaring that the vote constituted a "resounding defeat for the Odyssey proposal" and indicated that "there [was] little meaningful support for this kind of proposal." Six weeks later, following a

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2 Although the Odyssey Proposal called for the separation of all TWC's subsidiaries, prior to launching the contest, Odyssey had informed TWC's Chief Financial Officer, Frank Salizzoni, that it would be satisfied with a spinoff of the airline. It was TWA, after all, which was consistently losing money and adversely affecting the value of TWC's stock.

3 At the time, it had been announced that TWC had engaged Goldman Sachs & Co. to study "structural and financial alternatives" available to TWC and to report to TWC's Board of Directors "well ahead of the August 31 date specified in the Odyssey Proposal."

June 23, 1983 meeting with institutional investors, TWC declared:

> Trans World now has set targets that by 1987 its presently unprofitable airline subsidiary, TWA, should become a source of $100 million in pre-tax profits . . . .
>
> * * *
>
> [Chairman] Smart stated that Trans World's current outlook reflects the advantages of being an interrelated consumer-services company providing food services, transient and permanent lodging and *air transportation* to the public. [Emphasis added.]

The Prospectus

Against this backdrop, petitioners issued the July 29, 1983 prospectus. TWC's prior public statements in May and June had reaffirmed its commitment to the airline, even setting targets as far ahead as 1987. Nothing further was mentioned about Goldman Sachs' study of "structural and financial alternatives" commissioned in March 1983.

The July 29, 1983 prospectus spoke of a continuing relationship between TWC and TWA. The prospectus referred to "ongoing business relationships" and "continuing financial contractual arrangements and proposed transactions between TWA and [TWC] . . . ." It represented that by virtue of its ownership of a majority of TWA stock, TWC "will continue to be able to control matters voted on by stockholders of TWA." In a section titled "RELATIONSHIP BETWEEN TWA AND TRANS WORLD" the prospectus stated:

> There may in the future be other arrangements between TWA and Trans World (or other of its subsidiaries). It is intended that the terms of these arrangements will be determined on an arms length basis. There can be no assurance, however, that these terms will be favorable to TWA or that Trans World will continue to provide TWA with

the same level of support for TWA's financing and other needs as it has in the past.

The prospectus also advised that the public's equity in TWA might be increased "up to 40 percent assuming any required consent of lenders and stockholders of the two companies is obtained."

Consideration of a Spinoff

Although the prospectus clearly warned that the relationship between TWC and TWA might be adjusted in the future, there was no mention whatsoever of a possible complete separation of the two companies.[4] Behind the scenes, however, plans were being laid to jettison the airline. Its continuing losses acted as an anchor on the market value of TWC stock. In addition, both TWC and Goldman Sachs recognized that as long as the airline adversely affected TWC's performance, TWC would be vulnerable to another Odyssey-type proposal.

By July 7, 1983, Frank Salizzoni and Goldman Sachs were meeting to discuss spinning off the airline. At this meeting, it was agreed that Goldman Sachs' study of "structural alternatives"—originally scheduled to be presented to TWC's Board of Directors prior to the July 29 Offering—would be rescheduled for the next meeting of the Board, September 6, 1983.

There is also evidence in the record from which a jury could readily find that the July 29 Public Offering and the spinoff were two steps in an overall plan designed to infuse the ailing

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4 As the Court of Appeals noted:

> A jury might conclude that this language [in the prospectus], while anticipating revisions of the multitude of relationships existing between TWA and TWC, did not give any fair indication of the equally substantial possibility that TWA's status as a TWC subsidiary might be terminated. Indeed, the suggestions of diminished future support of TWA by TWC, and of possible future sales of some TWA stock, could both be read to imply that some continuing relationship between TWC and TWA, although one less favorable to the latter, was contemplated. 33a.

airline with enough public capital to prop it up, at least temporarily, and then spin it off so it would no longer burden the parent company, TWC. The handwritten notes of a Goldman Sachs representative in attendance at the July 7 meeting state under the heading "AIRLINE SALE/SPINOFF": "*primary* goal—build liquidity in airline & cut cord w/ TWC so they can walk away." (Emphasis in original).

The prospectus did not disclose that a spinoff was under consideration by TWC top management and Goldman Sachs, or even that Goldman Sachs' study of "structural alternatives" was still alive and was scheduled for presentation to TWC's Board of Directors only a month after the Public Offering. As far as public investors knew, separation of TWC and TWA was a dead issue; they would be investing in an airline which would continue to receive financial support from its parent and which was expected to return to profitability in the coming years.

The Goldman Sachs Study

The Goldman Sachs study confirms that the only "structural alternative" ever given serious consideration was a spinoff of the airline. As presented to TWC top management on August 18, 1983, the study consisted of only two sections: "TRANS WORLD AIRLINES, INC. AS AN INDEPENDENT ENTITY" and "TRANS WORLD CORPORATION AS AN ENTITY WITHOUT TWA." No other "structural alternative" was presented in the study, and Chairman Smart, in attendance at the August 18 meeting, confirmed that "the key issue was the airline."

Chairman Smart advised Goldman Sachs at this meeting that it was "supposed to look at all the strategic alternatives and the board will expect you to talk to all of them." In response to this admonition, Goldman Sachs made a cosmetic change to its study for the September 6 Board meeting by adding a *one page* preface listing "seven options", including a spinoff. The next *ninety-seven pages*, however, were still divided into the same two chapters: "TRANS WORLD AIRLINES, INC. AS AN INDEPENDENT ENTITY" and "TRANS WORLD CORPO-

RATION AS AN ENTITY WITHOUT TWA." No similar financial information was given as to any option other than a spinoff and only a perfunctory mention was made of the other options in Goldman Sachs' oral presentation to the Board.[5]

Approval of the Spinoff and Public Disclosure

On September 6, 1983, after Goldman Sachs' presentation, the Board turned the matter over to Frank Salizzoni—the chief proponent of the spinoff—for further study. Three weeks later, on September 27, the Board approved the concept of a spinoff and directed TWC management to develop a detailed program to accomplish that goal.

On September 28, 1983, in response to rumors in the market, TWC issued a press release stating, in pertinent part:

> The Board of Directors of Trans World Corporation today announced that it is *considering* the *possible* separation of TWA from Trans World Corporation. The Board instructed management to develop a detailed program under which the Company's 81 percent common stock holdings in Trans World Airlines, Inc. would be distributed to

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5 As to the "options" other than a spinoff (*See* Pet. at 6n.7):

(1) "Liquidation" was the same as the Odyssey proposal, which had been rejected by defendants and Goldman Sachs by April 1983. (b) "Sale of Whole Company" was never seriously considered and no valuations were prepared or presented to the Board. (c) "Sale of Other Subsidiaries" had been rejected months previously as not "one of the significant alternatives that should be considered by the board." (d) "TWC Continues to Sell Shares of TWA to Public as Market Permits", meant essentially to do nothing. It would not shield Transworld from the Airline's operating losses; and it would not satisfy institutional investors who had been lobbied to change their pro-Odyssey vote at the last minute. (e) "TWC Sells 20% of Hospitality Company in a Second Offering" (*i.e.* sell off part of profitable non-airline subsidiaries) also was never seriously considered by Goldman Sachs because it would not solve the airline problem. In addition, Goldman Sachs presented no financial data to the Board relevant to this "option". (f) "Do Nothing . . .", would invite another Odyssey-type proposal which this time would likely get the support of Transworld's institutional investors.

> Trans World Corporation's common stock holders, establishing TWA as a separate, publicly owned company. [Emphasis added].

The news that TWC was even "considering" the "possible" separation of TWA sent TWA's stock (including the preferred stock issued on July 29, 1983) into a tailspin. In the days immediately following the press release, the common and preferred stock lost almost one quarter of its value.

Clearly, given the critical nature of the relationship between TWA and TWC, "consideration" of even a "possible" spinoff was a matter of great significance to public investors. Under these circumstances, information concerning the then ongoing "consideration" of a "possible" spinoff by TWC top management and Goldman Sachs should have been disclosed in the July 29 prospectus so that investors could make up their own minds as to the possibility of a separation and whether they wanted to assume that risk.

The Proceedings Below

After the completion of discovery, petitioners moved for summary judgment on the grounds that the consideration given to a possible spinoff prior to the July 29 Public Offering need not have been disclosed. In support of their motion, petitioners relied on a series of cases holding that arms-length merger negotiations between independent parties need not be disclosed until an "agreement in principle" to merge is reached.[6]

The District Court relied on the rationale of these cases and granted summary judgment. The Court held first that "the issue of materiality arises only with respect to facts as to which there was a duty to disclose." 631 F. Supp. at 1263; 43a. It went on to find that "as a matter of law, defendants had no duty to

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6 *See Greenfield v. Heublein*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982). In the Petition, petitioners also rely on *Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir.), *cert. denied*, 108 S.Ct. 157, 98 L.Ed.2d 112 (1987).

disclose additional information, beyond that contained in the July 29 prospectus . . . ." *Id.* In making this determination, the District Court established a "bright-line test" analogous to the "agreement-in-principle" test set forth in the merger negotiation cases (*see* note 6, *supra*). The Court defined this test variously as "final corporate determination," "definitive action by the Board" or "first consideration of the question by those responsible for decision." 631 F. Supp. at 1264-65; 45a. Under each variation, however, it is clear that the District Court did not consider the significance of the information *to a reasonable investor* as mandated by *TSC v. Northway*, *supra*, 426 U.S. 438. Indeed, the court stated that "[d]isclosure may in fact be more misleading than secrecy so far as investment decisions are concerned." *Id.*

On appeal, the Court of Appeals for the Second Circuit reversed. Although the Court of Appeals did not question the "agreement-in-principle" test as used in the context of merger negotiations between independent parties,[7] it refused to adopt a similar rationale and apply a similar bright-line test in the circumstances presented here. 832 F.2d 733-34; 18a-23a. Instead, the Court of Appeals applied an analysis identical to that later applied by this Court in *Basic v. Levinson*, *supra*.

First, the court looked to *TSC v. Northway*, *supra*, 426 U.S. 438, noted that materiality is to be determined from the perspective of a reasonable shareholder, and held that the same standard applies to the element of materiality under § 11 of the Securities Act of 1933. 832 F.2d at 731, 735; 13a-14a; 23a. Next the Court of Appeals discussed the materiality of a contingent or speculative event and applied the "probability/magnitude approach" developed in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976

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7 The panel below was constrained to accept the prior decision of a separate panel in *Reiss v. Pan American*, *supra*, 711 F.2d 11 as binding in the context of merger negotiations. *See Board of Education of the City of New York v. Hufstedler*, 641 F.2d 68, 70 (2d Cir. 1981) (Second Circuit panel bound by prior Second Circuit panel decision unless overruled *en banc* or by the Supreme Court).

(1969) and adopted by this Court in *Basic v. Levinson*, *supra*, Slip Op. at 13-15. The Court of Appeals, like the District Court, noted that the relationship between TWC and TWA was "critical" to a reasonable investor contemplating a purchase of TWA stock. 832 F.2d at 735-36; 24a. Thus the magnitude of the prospective event, the spinoff, was extremely high. The court also, upon review of the record, determined that a reasonable jury could find that there was "a substantial possibility" that the spinoff would occur. *Id.* (as amended; 33a). Under these circumstances, held the court, it was a question for the jury to decide as to whether this "substantial possibility" of a highly important event "would have assumed actual significance in the deliberations of the reasonable shareholder" or would have "significantly altered the 'total mix' of information made available"—the standards set forth in *TSC v. Northway*, *supra*, 426 U.S. at 449.

REASONS FOR DENYING THE WRIT

The legal issues raised by the Petition were laid to rest in *Basic, Inc. v. Levinson*, *supra*, ____ U.S. ____ (No. 86-279 March 7, 1988).[8] The opinion below, in rejecting a bright-line test of materiality, and relying on *TSC v. Northway*, *supra*, 426 U.S. 438, and the probability/magnitude balancing test of *Texas Gulf Sulpher*, *supra*, 401 F.2d at 849, is entirely consistent with *Basic v. Levinson*.

Although petitioners attack the holding below that a jury issue is raised as to materiality where there was a "substantial possibility" that a spinoff would occur, that holding too is consistent with *Basic v. Levinson*. In *Basic*, this Court expressly agreed with the late Judge Friendly's analysis in *SEC v. Geon*

8 Petitioners did not have the benefit of *Basic v. Levinson* at the time they filed the Petition. Thus, they raise as their primary reason for granting the Writ that "this Court has not assessed specifically the proper standard of materiality for contingent events." Pet. at 10. That question was extensively addressed in *Basic* and the Court adopted the same "probability/magnitude" balancing test used by the Court below.

Industries, Inc., 531 F.2d 39, 47-48 (2d Cir. 1976) that where the magnitude of a contingent or speculative event is extremely high, information concerning it "can become material at an earlier stage than would be the case as regards lesser transactions." *Basic v. Levinson*, Slip Op. at 13. Indeed, this Court went on to provide examples of cases which were consistent with the "fact-specific inquiry" endorsed in *Basic*: "*SEC v. Shapiro*, 494 F.2d 1301, 1306-07 (2d Cir. 1974) (in light of projected very substantial increase in earnings per share, negotiations material, *although merger still less than probable*) . . . *Dungan v. Colt Industries, Inc.*, 532 F. Supp. 832, 837 (N.D. Ill. 1982) (fact that defendants were *seriously exploring* the sale of the company was material)." Slip Op. at 15 and n.19 (emphasis added).

The Petition raises no legal questions of general application or on which there is a conflict among the circuits. Instead, the Petition asks this Court to review the record and make its own judgment as to the "inferences a 'reasonable shareholder' would draw" from the facts in this case and the "significance of those inferences to him". But as this Court has held: Materiality "is to be determined on a case-by-case basis". *Basic v. Levinson*, Slip Op. at 24. The "delicate assessments" required to make this determination "are peculiarly ones for the trier of fact." *TSC v. Northway*, *supra*, 426 U.S. at 450.

Under these circumstances, the Writ should be denied.

I. CONGRESS HAS MANDATED A HIGH STANDARD OF DISCLOSURE IN REGISTRATION STATEMENTS AND PROSPECTUSES

In *Basic v. Levinson*, this Court reiterated that a "fundamental purpose" of the Securities Exchange Act of 1934, and § 10(b) thereof, was to "implement[ ] a philosophy of full disclosure". Slip Op. at 5; *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-78 (1977); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). In passing the 1934 Act, Congress had determined that:

> There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.

Basic v. Levinson, Slip Op. at 5, quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess., 11 (1934).

Similar concerns for full disclosure motivated Congress to enact the demanding requirements of the Securities Act of 1933 concerning issuance of securities to public investors. In the 1933 Act, Congress declared that prospective issuers must file a detailed registration statement with the SEC and provide potential investors with a prospectus containing much of the same information. *See* §§ 6, 7, 8 and 10; 15 U.S.C. §§ 77f, g, h and j. The fundamental purpose of these disclosure requirements was to place public investors on a par with issuers with respect to information about the company and its securities. *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 563 (E.D.N.Y. 1971); 77 Cong. Rec. 2917-18 (1933). Pursuant to this mandate, the SEC has required that "prominent emphasis be given in filed registration statements and prospectuses to material adverse contingencies." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 753 (1975).

The courts have taken care to effectuate the legislative intent. In *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 210 (2d Cir. 1980), the Court of Appeals recognized that the disclosure requirements of the Securities Act are "to ensure that the factors entering into prudent investment decisions are depicted in a standardized, comprehensible, and accurate manner." Accordingly, "close questions will generally be resolved in favor of the inclusion of information." *Id. See also, Feit v. Leasco Data Processing Equipment Corp., supra*, 332 F. Supp. at 571:

> Being a formal and legally required document, a prospectus must satisfy a high standard of disclosure—i.e., disclosure is required when only a relatively small percentage of traders would want to know before making a decision.

In order to enforce compliance with these principles, Congress provided an express private right of action under § 11 of

the 1933 Act which included a "stringent standard of liability." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381 (1983). As this Court noted, in order to establish a *prima facie* case under § 11, a plaintiff "need only show a material misstatement or omission." *Id.* at 382. Once materiality is shown, "[l]iability against the issuer of a security is virtually absolute." *Id.*

Public investors and market professionals have come to rely upon the prospectus as the primary, and most reliable source of information concerning securities being issued:

> Generally [other disclosures] would be insufficient to compensate for omissions in the prospectus since an investor is all too apt to look upon those communications as self-serving and to consider the prospectus as a more objective, self-contained statement upon which he may justifiably rely to make an informed investment decision.

Spielman v. General Host Corp., 538 F.2d 39, 40-41 (2d Cir. 1976) (*Per curiam*); *Accord*, *Fisher v. Plessy Co., Ltd.*, 559 F. Supp. 442, 446-47 (S.D.N.Y. 1983).

In the case at bar, as the Court of Appeals found below, there is sufficient evidence in the record to permit a jury to find that the July 29, 1983 TWA prospectus did not meet the exacting standards mandated by Congress.

II. A JURY COULD REASONABLY FIND THAT THE PROSPECTUS FAILED TO DISCLOSE MATERIAL INFORMATION NECESSARY TO MAKE THE STATEMENTS THEREIN NOT MISLEADING

A. The Standard of Materiality

Like the federal securities laws in general, § 11 of the 1933 Act is designed to proscribe dissemination of false or misleading information which is "material".[9] This Court has not yet explicitly defined a standard of "materiality" under § 11 of the 1933 Act. It has, however, addressed materiality under other sections of the federal securities laws.

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9 The complete text of § 11 is set forth at 46a.

In *TSC v. Northway*, *supra*, 426 U.S. 438, the Court defined the standard of materiality under § 14 of the 1934 Act (proxy solicitation), 15 U.S.C. § 78n, and concluded that an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. *Id.* at 449. The Court went on to explain:

> What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Id.

In *Basic v. Levinson*, the Court expressly adopted this same standard of materiality under § 10(b) of the 1934 Act and Rule 10b-5. Slip Op. at 6-7[10]. The Court also ruled that materiality is a consistent standard and does not depend upon the status of the person or entity bound to disclose. Slip Op. at 15 n.18 (refusing to devise "two different standards of materiality").

The *TSC v. Northway*, standard of materiality should also be applied under § 11 of the 1933 Act. The standard strikes a proper balance between too much and too little disclosure (*Basic*, Slip Op. at 6-7) and extension to § 11 would be consistent with this Court's refusal in *Basic* to adopt different standards of materiality for different circumstances. The lower courts have previously applied the *TSC v. Northway* definition under § 11, as did the Court of Appeals in the decison below. 832 F.2d at 731; 14a; *Ackerman v. Oryx Communications, Inc.*, 609 F. Supp. 363, 367 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 (2d Cir. 1987); *Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702, 708 (S.D.N.Y. 1979), *aff'd*, 618 F.2d 198 (2d Cir. 1980)

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10 The claims in the case at bar are also brought under § 10(b) and Rule 10b-5.

B. Materiality of a Contingent or Speculative Event

In *Basic v. Levinson*, the Court noted:

> Where . . . the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever present possibility that the contemplated transaction will not be effectuated, fall into [this] category.

Slip Op. at 7. The spinoff in the case at bar would likewise fall into this category of an event that is "contingent or speculative in nature."

To determine under what circumstances information concerning contingent or speculative events would be significant to a reasonable investor, this Court—like the Court of Appeals in the case at bar—turned to *SEC v. Texas Gulf Sulphur*, *supra*, 401 F.2d at 849, where the Second Circuit, sitting *en banc* held that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity." *Basic v. Levinson*, Slip Op. at 13; *Kronfeld v. TWA*, 832 F.2d at 731-32; 14a-15a. In *Basic*, the Court expressly agreed with the analysis of this probability/magnitude approach applied by the late Judge Friendly in *SEC v. Geon Industries*, *supra*, 531 F.2d at 47-48:

> Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.

Quoted in *Basic v. Levinson*, Slip Op. at 13.

Thus, as the magnitude of a contingent or speculative event increases, information concerning it can become material to reasonable investors even though occurrence of the event is still

less than probable, or cannot be said to be more likely than not. The Court underscored this point by explicitly stating that the analysis of the materiality of a contingent or speculative event set forth in *Basic* is consistent with the authorities it listed in foonote 19 of the opinion:

> *SEC v. Shapiro*, 494 F.2d 1301, 1306-07 (CA2 1974) (in light of projected very substantial increase in earnings per share, *negotiations material, although merger still less than probable*); *Holmes v. Bateson*, 583 F.2d 542, 558 (CA 1 1978) (Merger negotiations material although they had not yet reached point of discussing terms); *SEC v. Gaspar*, CCH Fed. Sec. L. Rep. (1984-85 Transfer Binder) ¶ 92,004 pp. 90,977-90,978 (SDNY 1985) (merger negotiations material although they did not proceed to actual tender offer); *Dungan v. Colt Industries Inc.*, 532 F. Supp. 832, 837 (ND Ill. 1982) (fact that defendants were *seriously exploring* the sale of their company was material[11] *American General Ins. Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744-745 (ED Va. 1980) (merger negotiations material four months before agreement in principle reached).

Slip Op. at 15n.19 (emphasis added). In the cases cited, clearly there was only a "substantial possibility"—if not less than that—that the contingent or speculative event would occur. The merger in *SEC v. Shapiro*, for example, was "less than probable" and the sale of the company in *Dungan v. Colt Industries* was only "seriously contemplated" and no actual negotiations had even begun.

This Court's citation of these cases as consistent with its holding in *Basic v. Levinson* conclusively demonstrates that the Court of Appeals applied the correct analysis in the case at bar.

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11 It is worth noting that in *Dungan*, the court determined that it was material that defendants were "seriously contemplating" the sale of the company even though there had been nothing more than a realization that it was a propitious time to sell (after the third profitable year in a row) and that they had "discussed the possibility of selling the company with certain unidentified interested parties." 532 F. Supp. at 835-36.

First, the court determined that the magnitude of the contingent or speculative event—the spinoff—was extremely high. Indeed, both the Court of Appeals and the District Court agreed that the relationship between TWC and TWA "was critical to the decisions faced by knowledgeable investors in evaluating TWA's value as an investment." 832 F.2d at 735-36; 24a; 631 F.2d at 1263; 43a. The Court of Appeals also determined, after review of the record, that:

> The likelihood of the event's occurrence cuts much less sharply in favor of plaintiff [respondent], *but there was certainly, at a minimum, a substantial possibility of its occurrence.*

33a (emphasis added). Under these circumstances, held the court, it was for the jury to decide whether a reasonable investor would consider it significant in making his investment decision that there was a "substantial possibility" that the "critical" relationship between TWC and TWA would be adversely changed. This holding is particularly appropriate in that the prospectus did undertake to make a number of statements indicating a continuing relationship between TWC and TWA, but contained not a word that, at the time of its issuance to the public, TWC top management and Goldman Sachs were seriously considering, if not actually planning, a severence of that "critical" relationship.

The holding below is further buttressed by the quick and violent reaction of the stock market to the September 28, 1983 announcement that TWC's Board was merely "*considering* the *possible* separation of TWA." (Emphasis added). If Board "consideration" of a "possible" spinoff was highly material to public investors, judging from the market reaction,[12] how can it be said—as a matter of law—that it would have been of no sig-

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12 One indicia of materiality is "if the information omitted (or misstated) 'in reasonable and objective contemplation might affect the value of the corporation stock or securities . . . .' " *United States v. Carpenter*, 791 F.2d 1024, 1032n. 9 (2d Cir. 1986), *aff'd*, 108 S.Ct. 316, 98 L.Ed.2d 275 (1987) *See also*, *SEC v. Gaspar*, *supra*, (1984-85 Transfer Binder) Fed. Sec. L. Rep. (CCH) at p. 90,978.

nificance to reasonable investors that top management and Goldman Sachs were "considering" a spinoff and that such a proposal would be presented to the Board shortly after the July 29, 1983 Public Offering? On this record the court below was clearly correct in letting a jury make the required "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . ." *TSC v. Northway*, *supra*, 426 U.S. at 450.

II. THE REASONS OFFERED BY PETITIONERS FOR GRANTING THE WRIT WERE ALL ADDRESSED AND REJECTED BY THIS COURT IN *BASIC v. LEVINSON*

Petitioners offer essentially three reasons why they feel the decision below should be reversed: (1) "The majority's decision creates a disclosure standard that would be incredibly burdensome, if not impossible, for issuers to meet." (Pet. at 11); (2) "The direct result of the Second Circuit's 'possibility' standard would be to bury shareholders under carefully-phrased and essentially meaningless disclosures about 'possible' future events." (*id.*);[13] and (3) "[T]he Court of Appeals' decision would sound the death knell for summary judgment in securities actions . . . ." (Pet at 12). Each of these points was considered and rejected in *Basic v. Levinson*.

Petitioners' first argument is no different than the rationale for the easier-to-follow, bright-line "agreement-in-principle" test that this Court found in *Basic* "to be directed solely at the comfort of corporate managers." The Court's reasons for rejecting that rationale apply with equal force here:

> A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions. Any approach that designates

13 We have already noted petitioners' exaggeration of the holding below. *See* p. 3, *supra*.

> a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive.

Slip Op. at 11. The Court also noted that, after much study, the Advisory Committee on Corporate Disclosure had reached the same conclusion:

> "Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the [SEC] is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as problems are identified."

Id. at 11 n.14, quoting Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission 327 (House Committee on Interstate and Foreign Commerce, 95th Cong. lst Sess.) (Comm. Print) (1977).

Petitioners' second argument—that investors would be buried and confused by meaningless disclosure—was also rejected in *Basic v. Levinson*. This argument, noted the Court,

> "assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing." *Flamm v. Eberstadt*, 814 F.2d at 1175. Disclosure, and not paternalistic withholding of accurate information is the policy chosen and expressed by Congress.
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> * * *
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> The role of the materiality requirement is not to "attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations," *Flamm v. Eberstadt*, 814 F.2d at 1175, but to filter out essentially useless information that a reasonable investor would not consider significant, even as part of a larger "mix" of fac-

tors to consider in making his investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 448-449.

Slip Op. at 9. *See also*, *Sonesta International Hotels Corp. v. Wellington Associates*, 483 F.2d 247, 251 (2d Cir. 1973) ("[a] reasonable shareholder, once informed of the contingency, can determine whether to assume the risk of its occurrence or non-occurrence . . . .").

Petitioners' third argument—that the decision below sounds the "death knell" for summary judgment in securities actions—is obviously an exaggeration. Long before the decision below, this Court had determined that questions of materiality were "peculiarly ones for the trier of fact." *TSC v. Northway*, *supra*, 426 U.S. at 450. The decision in *Basic v. Levinson* reiterates that a question of materiality, and particularly as it relates to contingent or speculative events, is a "fact-specific inquiry" (Slip Op. at 15) "and thus is to be determined on a case-by-case basis." (*Id.* at 24) To the extent summary judgment is rendered more difficult by these holdings, petitioners' dispute is with the decisions of this Court, not with the opinion below.

CONCLUSION

For the reasons set forth above, the Petition for Writ of Certiorari should be denied.

Dated: March 17, 1988

Respectfully submitted,

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